87-341

Supreme Court, U.S.
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IN THE

Supreme Court of The United States

October Term, 1987

No.

WILLIAM E. CAMPBELL AND GWENDOLYN J. CAMPBELL,
Petitioner,

VERSUS

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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39 pp

QUESTIONS PRESENTED

1. Are losses from a joint venture which is not itself engaged in a trade or business, but which is created and operated by the taxpayer as part of the taxpayer's trade or business, properly includable in the computation of the taxpayer's net operating loss under Internal Revenue Code Section 172(d)(4)?

2. May a circuit court render a decision in favor of the government in a tax case based on the circuit court's determination that the taxpayer failed to meet the burden of proof, when the district court, due to its contrary view of the applicable law, failed to make findings of fact which would support the judgment under the law as set forth in the circuit court's decision?

LIST OF PARTIES

William E. Campbell and Gwendolyn J. Campbell,
Petitioner
United States of America, Respondent

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OPINIONS BELOW

The opinion of the district court is reported at 581 F. Supp. 1274 (N.D. Tex. 1984) and is included as Appendix A. The district court's judgment is included as Appendix B. The opinion of the Court of Appeals is reported at 813 F.2d 694 (5th Cir. 1987) and is included as Appendix C. The judgment of the Court of Appeals is set forth as Appendix D. The order denying Mr. and Mrs. Campbell's Petition for Rehearing is set forth as Appendix E.

STATEMENT OF JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was entered on April 1, 1987. Mr. and Mrs. Campbell's Petition for Rehearing was denied on May 29, 1987. The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. §1254(1).

APPLICABLE STATUTES

Section 172(d)(4) of the Internal Revenue Code* provides in pertinent part:

> In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business.

Federal Rule of Civil Procedure 52(a) provides in pertinent part:

> In all actions tried upon the facts without a jury . . . the court shall find the facts specially and state separately its conclusions of law thereon . . .

STATEMENT OF THE CASE

Petitioners William E. and Gwendolyn J. Campbell filed joint federal income tax returns reporting taxable losses for the years 1976 and 1977. The losses represented Mr. Campbell's share of operating losses from real estate joint ventures formed and operated by Mr. Campbell. Mr. Campbell carried these losses back to receive refunds of taxes paid by him in 1973 and 1974.

The Internal Revenue Service asserted deficiencies for the years 1976 and 1977, and disallowed the inclusion of the losses in a net operating loss carryback. Mr. and Mrs. Campbell paid the 1976 and 1977 deficiencies and sued the government for a refund. The government counterclaimed for 1973 and 1974 taxes as a result of the disallowance of the loss

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* References to the Internal Revenue Code of 1954 as in effect for the years in issue are hereinafter made by section number only.

carryback. Jurisdiction of the district court was predicated upon 28 U.S.C. §1346.

The district court ruled that a portion of the losses incurred by Mr. and Mrs. Campbell was eligible for carryback to 1973 and 1974. The court divided the losses into eligible and noneligible categories based on its perception of Mr. Campbell's intent in forming the joint ventures. Where the district court found an intent beyond passive investment, it considered the Campbells' losses from such joint ventures to fall within the net operating loss provisions of Section 172. The district court did not believe it necessary to look to the activities of the joint ventures; and it, therefore, made no findings as to whether or not each individual joint venture was engaged in a trade or business.

The Court of Appeals for the Fifth Circuit determined that in order to be eligible for inclusion in a net operating loss carryback under Section 172(d)(4), the Campbells must establish that each of the joint ventures was engaged in a trade or business, regardless of whether or not the existence and operation of each joint venture could be considered a part of Mr. Campbell's trade or business. Because "the taxpayers bore the burden of proof on this issue as to each partnership," and because the record did not establish that each of the joint ventures was independently engaged in a trade or business (since the district court did not even consider this based on its perception of the applicable law), the court of appeals rendered a decision for the government. Requesting review of this decision by the Court of Appeals for the Fifth Circuit, William E. and Gwendolyn J. Campbell file this petition.

Two conclusions of the court of appeals are at issue: (1) the court's determination that even when a taxpayer creates and operates a partnership as part of his trade or business, the

phrase "attributable to a trade or business" contained in Section 172(d)(4) refers exclusively to the trade or business of the partnership, and not of the partner; and (2) the court's determination that judgment should be rendered in favor of the government because the taxpayer failed to meet his burden of proof, even though the district court failed to make the necessary findings of fact due to its contrary view of the applicable law.

REASONS FOR GRANTING THE WRIT

A. Introduction

Section 172, entitled Net Operating Loss Deduction, is a taxpayer relief provision. Under Section 172 taxpayers may carry certain "net operating losses" incurred in one year backward or forward to offset income generated in another year. The losses eligible for inclusion in the net operating loss of a non-corporate taxpayer are limited to those "attributable to a trade or business" under Section 172(d)(4). Section 172 is then, a business income averaging device,

> enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. [The provisions] were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year.

Libson Shops v. Koehler, 353 U.S. 382, 386 (1957). *See also United States v. Foster Lumber Co., Inc.*, 429 U.S. 32, 42 (1976); H.R. Rep. No. 855, 76th Cong., 1st Sess., 9 (1939); H.R. Rep. No. 1337, 83rd Cong., 2nd Sess., 27 (1954). Other than the case at bar, no reported decision appears to have dealt with the application of Section 172 in the instant context.

B. The Phrase "Attributable To A Trade Or Business" In Section 172(d)(4) May Be Satisfied By Looking To The Trade Or Business Of The Partnership Or Of The Partner.

Petitioner's position in this case has been very simply that as Mr. Campbell is in a trade or business and as the losses incurred are attributable to that trade or business, the losses are not barred from inclusion in his net operating loss by Section 172(d)(4). The government has not disputed that Mr. Campbell is in a trade or business, nor that the joint venture losses are attributable to Mr. Campbell's trade or business. Instead, the government argued, and the circuit court agreed, that Mr. Campbell failed to prove that the joint ventures were each individually engaged in a trade or business, and hence the losses could not be considered attributable to a trade or business for purposes of Section 172(d)(4).

The Fifth Circuit opinion does not look to the purpose or operation of Section 172. Instead, the court concludes without analysis that because it has held that the determination of ordinary and necessary business deductions of a partnership are determined exclusively at the partnership level, a similar approach should be taken for net operating losses under the taxpayer relief provisions of Section 172. Continuing to dance around the issue instead of addressing it, the court then cites obvious tenets of partnership tax law from *Barham v. United States*, 301 F. Supp. 43 (M.D. Ga. 1969), *aff'd per curiam* 429 F. 2d 40 (5th Cir. 1970), and *United States v. Basye*, 410 U.S. 441 (1973). The discussion of Section 172(d)(4) ends with this quote from *United States v. Basye* (at 448):

> While the partnership pays no taxes, 26 U.S.C. §701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this pur-

> pose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership was merely an agent or conduit through which the income passed.

The Fifth Circuit notes that its opinion "is consistent" with the statement in *Basye*. The Fifth Circuit fails to note, however, that Mr. Campbell's position is equally consistent with *Basye*. Mr. Campbell took his share of bottom line losses from the joint ventures, losses computed by each joint venture as a separate entity, and then included each loss as part of his net operating loss. Nowhere does *Basye* suggest this to be an inappropriate treatment. In fact, the holding in *Basye* rejects the strict entity approach to partnership taxation, which is the approach taken by the Fifth Circuit in this case. The Fifth Circuit has made a tax policy decision based on a perceived need for consistency between largely unrelated Internal Revenue Code provisions, instead of based on the purpose and language of the statute.

The Fifth Circuit decision in effect renders Section 172 meaningless for a large group of taxpayers that choose to operate parts of their business through partnerships. The real estate industry is full of Bill Campbells, entrepreneurs who chose to acquire properties with "equity financing," i.e., by allowing a few investors to become the entrepreneur's partners with respect to a particular property because the entrepreneur alone does not have the financial capabilities to acquire the desired property. Interestingly, the government did not challenge Mr. Campbell's inclusion in his net operating loss of losses incurred on properties owned outright by him. When Mr. Campbell seeks financial assistance to expand

his business in acquiring new properties, however, the Fifth Circuit requires that the whole focus of the net operating loss inquiry be changed. Somehow, under the Fifth Circuit's reasoning, equity financed properties are less a part of Mr. Campbell's trade or business than debt financed properties.

Particularly in light of the Tax Reform Act of 1986, which encourages taxpayers to undertake ventures in a non-corporate form, the Fifth Circuit decision artificially pushes entrepreneurs to debt rather than equity financing (corporations are not subject to the Section 172(d)(4) restrictions). Under the petitioners' interpretation of the statute, the Tax Code remains a neutral factor in the marketplace, and Section 172 operates as intended, to average income for non-corporate taxpayers involved in cyclical businesses. Moreover, the results for the investor partners are unchanged from the government's position: under either analysis the investor partners' shares of joint venture losses are not attributable to any trade or business, and therefore would remain ineligible for inclusion in their respective net operating losses.

The Fifth Circuit decision simply misses the issue. Section 172(d)(4) was not drafted to exclude entrepreneurs from benefiting from net operating loss relief. The Fifth Circuit concern with consistency of analysis for Sections 162(a), 1221(1) and 172(d)(4) in a partnership context fails to consider the differences in language and purposes of those provisions, and as a result leaves all entrepreneurs who use equity financing to build their businesses without any method to achieve level tax liability in a climate of cyclical income.

C. As A Consequence Of The District Court's Contrary View Of The Law, No Findings Of Fact Necessary To Support The Ruling Given By The Appellate Court Exist, And It Is Therefore Necessary That The Case Be Remanded To The District Court.

Even if it were to be found that the Fifth Circuit was correct in its view that a determination must be made as to each partnership's trade or business activities, the district court, given its contrary perception of the applicable law, failed to make any findings in this regard. The Fifth Circuit concluded, despite these circumstances, that the Campbells failed to meet their burden of proof. The practical effect of the Fifth Circuit holding has been to deprive the taxpayers of any ability to meet their burden and show that the various individual partnerships were engaged in a trade or business, as required by the circuit court.

Both Respondent and Petitioners disagreed with the legal reasoning used by the district court, and both presented alternative constructions of Section 172(d)(4) to the court of appeals. The court of appeals chose the government's construction, stating that for purposes of Section 172(d)(4), the attribution of a partnership loss to a trade or business must be made exclusively at the partnership level.

The reasoning used by the district court is directly counter to that which would be necessary to reach a conclusion under the law as set forth in the appellate court decision. The Fifth Circuit requires an exclusive look to the partnership level. The district court looked exclusively at the activities of Mr. Campbell, the individual partner.

As a consequence of making its analysis under a contrary view of the law, the district court made no findings of fact whatsoever as to whether any of the partnerships in which Mr. Campbell owned an interest were engaged in a trade or

business. Under the district court's legal analysis that issue was never reached. Rather than remanding the case to the district court for further findings, however, the Fifth Circuit rendered a decision for the government, noting that the taxpayer "bore the burden of proof on this issue as to each partnership."

The Fifth Circuit's reference to the burden of proof is clearly inappropriate in a situation where, due to a contrary view of the law, the district court made no findings of fact at all. With no findings of fact, it cannot be determined whether or not the burden of proof was met. Federal Rule of Civil Procedure 52(a) requires, in trials before the court, that findings of fact be made on all factual issues necessary to a decision. When the necessary findings are not made, the proper appellate judgment should vacate the district court decision and remand the case for further proceedings consistent with the appellate decision. *See generally* Wright & Miller, *Federal Practice & Procedure* Section 2577 (1971), 5A *Moore's Federal Practice* ¶ 52.06[2] (1986), and cases cited therein. The Fifth Circuit, however, has apparently decided that the general rule is inapplicable in tax cases. As authority for this proposition, the court cites only *Zell v. Commissioner*, 763 F.2d 1139 (10th Cir. 1985), a tax protestor case.

Outside the tax area, there does not seem to be much dispute as to the appropriate appellate court action when the district court has failed to make findings and fact due to a contrary view of the law. "When an appellate court discerns that a district court has failed to make a finding because of an erroneous view of the law, the usual rule is that there should be a remand for further proceedings to permit the trial court to make the missing findings . . ." *Pullman-Standard v. Swint*, 456 U.S. 273, 291 (1982). *See also Rule v. International Association of Bridge, Structural and Ornamental Ironworkers*, 568

F.2d 558 (8th Cir. 1977) and *United States v. O'Connell*, 496 F.2d 1329 (2nd Cir. 1974).

The Fifth Circuit correctly held that the taxpayers bore the burden of proof as to the issues in question. It simply does not follow, however, that when findings of fact are not made, the taxpayers are deemed to have failed to meet their burden of proof. Rule 52(a) does not disappear in tax cases.

CONCLUSION

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

DATED: August 26, 1987.

Respectfully submitted,

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APPENDIX A

IN THE
UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

CA-3-82-1738-C

WILLIAM E. CAMPBELL and
GWENDOLYN J. CAMPBELL

vs.

UNITED STATES OF AMERICA

OPINION

I. INTRODUCTION

Plaintiff, William E. Campbell, is in the real estate business. He is the sole owner of a corporation that brokers real estate. He also brokers real estate individually. Plaintiff is also the sole owner of various parcels of real estate. Lastly, he is a partner in several real estate joint ventures.

In taxable years 1976 and 1977, Mr. Campbell had losses in his individual real estate dealings that amounted to $58,445.14 and $96,845.69, respectively.

In those years, he had losses of $278,641.83 and $252,588.15 as his distributive share of losses incurred by the real estate joint ventures.

Mr. Campbell reported his individual losses on Schedule C of his '76 and '77 returns and reported his distributive share losses on Schedule E of those returns.

Plaintiffs filed joint returns for the years 1976 and 1977 and wish to carry the losses shown back to the taxable years 1973 and 1974, when Mr. Campbell was single and had significant amounts of income.

Plaintiffs and the Defendant reached an impasse so this Civil Action was filed under 28 U.S.C. §1346(a)(1).

Loss carry backs are possible under Section 172(a) of the Internal Revenue Code of 1954 (part of 26 United States Code) (unless otherwise stated all sections cited hereafter will be to the I.R.C. of 1954), which provides in (a) that: "*Deduction Allowed.* — There shall be allowed as a deduction for the taxable year an amount equal to . . . (2) the net operating loss carry back to such year . . ."

There is a limitation to these loss carry backs which is expressed in Section 172(d)(4) as:

> (4) *Nonbusiness Deductions of Taxpayers Other Than Corporations.* — In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business . . .

The Parties are not contesting the allowability of the expenses but do differ over whether they are attributable to Plaintiffs', Mr. Campbell, trade or business.

If any or all of these expenses are allowable, the Parties dispute whether the full allowable expenses may be carried back or if only one-half may be carried back to Mr. Campbell's taxable years when he was not married.

II. SCHEDULE C DEDUCTIONS

Mr. Campbell testified at trial that these expenses are related to his personal real estate brokerage activities.

Mr. Campbell finds properties that are probably, and hopefully, in areas of future growth. The goal is to purchase property at agricultural value and sell it at urban develop-

mental value. Mr. Campbell takes title to these properties while he puts together joint ventures to hold the properties. When he takes title to these properties, he has no intention to hold them for investment. Mr. Campbell derives his profits from these land exchanges from his brokerage fees, which the Defendant does not appear to dispute to be ordinary income. Mr. Campbell's undisputed testimony was that the disputed Schedule C expenses were related to this production of ordinary income. Therefore, these expenses are in connection with Mr. Campbell's trade or business and are allowable.

III. SCHEDULE E DEDUCTIONS

The real estate joint ventures in dispute were formed before Plaintiffs' marriage in February, 1976. Mr. Campbell testified that he entered into these ventures because oftentimes, the other venturers were unsophisticated in the real estate field. He believes that the unsophisticated investors do feel better about their investments when he also takes part in the venture. He did say, though, that he also joins to the ventures to make a profit off the enhancement of value of the venture properties.

The Defendant entered into evidence its Exhibit #4, the joint venture agreement for an entity known as Rowlett Creek Company. This contract was put in evidence as a typical example of the agreements for the joint ventures in question.

Section 1.03 of Exhibit #4 provides that the purpose of that contract is to acquire the subject piece of property "for investment purposes only, . . ."

Section 4.01 of Exhibit #4 sets out that Mr. Campbell is a 50% owner of this joint venture. Defendant's Exhibits #1 and #2 show that Mr. Campbell does have a small, 1 or 2 percent

interest in a few of the joint ventures but otherwise has interests ranging from 10 to 50 percent with a 75 percent interest in one venture.

It may also be pertinent that the other 50% of this particular venture is owned by a very large local bank as trustee for the bank's retirement fund.

Plaintiffs' principal contention is that Mr. Campbell is in the real estate business, from top to bottom, and from side to side. As he is totally in the real estate business, the limitation of Section 172(d)(4) does not apply to him and the losses should be characterized as to him and not as to the joint venture partnerships.

The Court is of the opinion that it makes no difference to the outcome of this controversy if the character of the losses is determined by attribution to Mr. Campbell or the various joint ventures.

The losses that Plaintiffs want to carry back are for such things as interest, depreciation, taxes, insurance, professional fees, and other expenses relating to the rental of the various properties as farm land.

This is important as Mr. Campbell wears more than one hat in relation to these joint ventures. First, he locates the land and either takes title to it in his name and then syndicates it into a joint venture or directly syndicates it into a joint venture. He then takes an ownership interest in the joint venture. But he is also named in the joint venture agreement to be the manager of the joint venture, serving without compensation but being reimbursed for his expenses. Last, either Mr. Campbell or his wholly owned corporation, Campbell Company of Dallas, Inc. sells the land for the joint venture.

Thus, Mr. Campbell either directly, or indirectly makes three separate profits from the joint ventures in question. He makes a profit when he locates the land and syndicates it into a joint venture. There is no dispute that this is part of his trade or business. He makes two profits, one directly, one directly or indirectly, upon the sale of the property. The profit for acting as a broker is also gain from his trade or business. The third profit is a result of Mr. Campbell's ownership of an interest in a joint venture which sells its piece of property.

Mr. Campbell's first two profits are undoubtedly ordinary in nature. The rub comes, when his profit (or loss) off his ownership interests is considered.

There are, undoubtedly, a few joint venture interests that Mr. Campbell holds in which any expectation of profit because of an increase in value of the land is minimal or de minimus. These interests are in the joint ventures in which Mr. Campbell has less than a 5% interest in the joint venture. It is apparent that these small interests were undertaken as an inducement to prospective joint venturers. These investments appear to have been made in the ordinary course of business and, therefore, the yearly expenses may be taken as ordinary deductions.

The remainder of Mr. Campbell's joint venture interests are at least 10% interests in their respective ventures. Though such determinations can never be set in concrete, it appears to the Court that Mr. Campbell had a significant motive to profit by the increase in value of the underlying land so that it cannot be said that the investments were made in the ordinary course of his real estate business.

The case of *Moller v. United States*, 83-2 U.S.T.C., para. 9698 (Fed. Cir., 1983), points out that the amount of time spent managing an investment is not determinative of

whether or not a taxpayer is engaged in the ordinary course of a trade or business. That Mr. Campbell may spend a large amount of time overseeing the development of the properties owned by the joint ventures does not mean that his ownership interest in those non-minimal investments is in the course of his real estate business. This is particularly so as Mr. Campbell anticipates receiving ordinary income directly or indirectly, through his wholly owned corporation, in the form of brokerage fees when the various joint venture properties are sold.

IV. LOSS CARRY BACKS

Plaintiffs have cited *Wasson v. United States*, 250 F.2d 826 (5th Cir., 1958), cert. denied, 358 U.S. 815 (1958), for the proposition that 100% of the deductions related to Mr. Campbell's separate property that could not be taken in the respective years of 1976 and 1977 should be carried back to prior years. That case is clearly distinguishable. In that instance, the Plaintiff suffered a diminution of his separate property; some sheep and cattle died. This is a far different situation from the one now before this Court.

The deductions that Plaintiffs wish to have Mr. Campbell solely carry back are for such things as interest and taxes paid and for professional fees paid out of pocket expenses. This situation is covered by the case of *Stewart v. Commissioner of Internal Revenue*, 95 F.2d 821 (5th Cir., 1938). That opinion specifies, at p. 822, "Since, one-half of the community income is to be taxed to the husband, it follows that the applicable deductions should also be divided between the husband and wife."

It appears from *Vallone v. Vallone*, 644 S.W.2d 455 (Tex., 1983), that the extensive time that Mr. Campbell spends on his real estate investments belongs to the community of the

Plaintiffs. Therefore, any such profits, presumptively belong to the community. Under *Stewart*, above, the deductions belong to the community and must be taken one-half by each.

It is only logical, that if Mr. Campbell can only take one-half of these deductions on a current return, he can only carry back the unused portion of his one-half of the deductions.

CONCLUSION

The Parties have agreed to do the arithmetic to put into effect this Court's rulings and present a judgment in accord with its rulings which the Court will sign and have entered.

WILLIAM TAYLOR, SR.
United States District Judge

March 26, 1984
Date

APPENDIX B

IN THE
UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

CIVIL NO. CA-3-82-1738-R

WILLIAM E. CAMPBELL and
GWENDOLYN J. CAMPBELL,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

FINAL JUDGMENT

FINAL JUDGMENT IS HEREBY ENTERED for the Defendant United States of America and against the Plaintiffs, William E. Campbell, Jr. and Gwendolyn J. Campbell as follows:

1. As to Plaintiff's claim for refund for tax year ended December 31, 1976, Plaintiff takes nothing and said claim is dismissed with prejudice;

2. As to Defendant's Counterclaim Judgment is awarded to Defendant and against Plaintiff in the amount of $184,506.60 ($126,642.92 tax plus $57,863.68 interest paid) for tax year ended December 31, 1973 and for $53,625.38 ($38,665.53 tax plus $14,959.85 interest paid) for tax year ended December 31, 1974, plus accrued interest as provided by law under applicable provisions of the Internal Revenue Code.

3. Costs are adjudged against Plaintiff.

ENTERED this 25th day of February, 1986.

JERRY BUCHMEYER
United States District Judge

APPENDIX C

UNITED STATES COURT OF APPEALS
FIFTH CIRCUIT

No. 86-1212

WILLIAM E. CAMPBELL and
GWENDOLYN J. CAMPBELL,
Plaintiffs-Appellants
Cross-Appellees,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee
Cross-Appellant.

April 1, 1987

Taxpayers brought action seeking determination that real estate partnership losses were net operating losses, thus making them available for carry back to offset taxpayers' income in earlier years. The United States District Court for the Northern District of Texas, Jerry Buchmeyer, J., 581 F.Supp. 1274, held that some losses were net operating losses and others were not, and appeals were taken. The Court of Appeals, Edith H. Jones, Circuit Judge, held that taxpayers' real estate partnerships were only investment vehicles, where properties generally consisted of farmland located in areas of potential urban development whose only source of income pending resale by partnerships was farm rentals, and thus losses incurred by partnerships were investment losses and were reportable as such on taxpayers' returns.

Affirmed in part, reversed in part, and rendered.

Synopsis, Syllabi and Key Number Classification
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The Synopsis, Syllabi and Key Number Classification constitute no part of the opinion of the court.

1. Internal Revenue Key 3920

Taxpayers, who were partners in real estate partnerships, could not include partnerships' losses in calculating taxpayers' net operating losses unless losses were incurred in partnership's trade or business. 26 U.S.C.A. §§172(d)(4), 702(b).

2. Internal Revenue Key 3920

Taxpayers' real estate partnerships were only investment vehicles where properties generally consisted of farmland located in areas of potential urban development whose only source of income pending resale by partnerships was farm rentals, and thus losses incurred by partnerships were investment losses and were reportable as such on taxpayers' returns. 26 U.S.C.A. §172(d)(4).

Appeal from the United States District Court for the Northern District of Texas.

Before VAN GRAAFEILAND*, HIGGINBOTHAM, and JONES, Circuit Judges.

EDITH H. JONES, Circuit Judge:

Taxpayers William E. and Gwendolyn J. Campbell appeal the decision of the district court that losses from certain real estate limited partnerships were not includable in taxpayers' net operating losses because they were not incurred in taxpayers' "trade or business." The government cross-appeals the district court's contrary finding in regard to losses incurred by others of taxpayers' limited partnerships, 581 F.Supp. 1274 (D.C.Tex.1984). We affirm in part and reverse in part.

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* Circuit Judge of the Second Circuit, sitting by designation.

Mr. Campbell owns interests in a number of real estate partnerships, each of which, in turn, owns a parcel of real property. In 1976 and 1977, the partnerships generated losses, which were passed through to all the partners, including Mr. Campbell. The principal question in this case is whether the taxpayers may include these losses in calculating their net operating losses for 1976 and 1977, thus making them available for carryback to offset income in earlier years under 26 U.S.C. §172(b). Section 172(d)(4) provides that only business deduction items may be used in calculating net operating loss. The district court included in taxpayers' net operating loss the business losses incurred by certain of taxpayers' investments in real estate partnerships, while excluding losses incurred from other such partnerships, and stated that "it makes no difference to the outcome of the controversy if the character of the losses is determined by attribution to Mr. Campbell or the various joint ventures."

The taxpayers contend initially that we should focus on Mr. Campbell's trade or business in real estate and permit the deduction of partnership losses because they derive from his trade or business. Contrary to this analysis, the attribution of a loss to a trade or business purpose must be made at the partnership level. The Internal Revenue Code provides that a partner's distributive share of partnership income, gain, loss, deduction, or credit shall be determined "as if such item were realized . . . or incurred in the same manner as the partnership." 26 U.S.C. §702(b). We have held that under §702(b), partnership business deductions may be attributed to the individual partner-taxpayer only if such deductions were incurred in the partnership's trade or business pursuant to 26 U.S.C. §162(a). *Tallal v. Commissioner*, 778 F.2d 275, 276 (5th Cir.1985). We perceive no justification for distinguishing between §172(d)(4) and §162(a) in this respect.

Campbell asserts, however, that §172(d)(4), which provides that the "taxpayer's" business deductions shall be used in calculating net operating loss, requires a different result. He urges that the definition of "taxpayer" does not include a "partnership," therefore, any business deductions incurred in Campbell's real estate business are includable in calculating his net operating loss. A similar argument was advanced, and rejected, in *Barham v. United States*, 301 F.Supp. 43 (M.D.Ga. 1969) *aff'd per curiam*, 429 F.2d 40 (5th Cir.1970) (adopting district court's opinion). There, taxpayer contended that certain joint venture real estate was a capital asset because it was not held "for sale to customers in the ordinary course of *his* trade or business" within the meaning of 26 U.S.C. §1221(1). Despite this language, the court concluded that the Code ties the taxable status of gain or loss to whether the partnership held the land in the course of *its* trade or business. This holding is consistent with the Supreme Court's statement in *United States v. Basye*, 410 U.S. 441, 448, 93 S.Ct. 1080, 1085, 35 L.Ed.2d 412 (1973):

> while the partnership itself pays no taxes, 26 U.S.C. §701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. *Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.* (emphasis added).

[1] Thus, under §172(d)(4), it is first necessary to determine the nature of gain or loss generated by the partnership's activities. If a partnership incurs trade or business losses, the

partner accounts for a distributive share of the trade or business loss. Conversely, the partnerships' investment loss should be reflected in the partner's distributive share as an investment loss.

[2] The taxpayers argue alternatively that each of the partnerships for which loss deductions were claimed was involved in the trade or business of farming rental and with the motive of ultimately making a profit. We cannot agree. The taxpayers bore the burden of proof on this issue as to each partnership. See *Zell v. Commissioner*, 763 F.2d 1139, 1142 (10th Cir.1985). Each limited partnership in which Mr. Campbell was a part owner and general manager was formed "for investment purposes only" according to its governing articles and owned one parcel of real estate. The properties generally consisted of farm land located in areas of potential urban development whose only source of income pending resale by the partnership was farm rentals. Annual expenses on the properties in 1976 and 1977, on average, exceeded their rental income by factors of 20:1. Even though the rent received on some properties was not nominal, it was much less than the associated expenses. The record does not establish that the partnerships made any investments to develop the properties for non-farm use, aside from paying Campbell's expenses as a manager to encourage governmental authorities to pursue favorable policies in the vicinity of the partnership tracts. It is true that a single rental property may constitute a trade or business within 26 U.S.C. §162, see, e.g., *Hazard v. Commissioner*, 7 T.C. 372 (1946), if it is operated with the motive of making a profit. See *Tallal v. Commissioner*, 778 F.2d at 276. Viewed from the standpoint of their self-described objective and methods of operation, however, Campbell's limited partnerships were only investment vehicles. Therefore, these partnerships cannot be said to be in the rental business for the purposes of §172(d)(4).

We need not reach the other issues raised by the taxpayers, which are premised on their succuss in the foregoing matter.

For the reasons here discussed, the judgment of the district court is AFFIRMED in Part, REVERSED in Part, and herewith RENDERED in favor of the United States.

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APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 86-1212

D.C. Docket No. CA-3-82-1738-R

WILLIAM E. CAMPBELL and
GWENDOLYN J. CAMPBELL,

Plaintiffs-Appellants
Cross-Appellees,

versus

THE UNITED STATES OF AMERICA,

Defendant-Appellee
Cross-Appellant.

Appeals from the United States District Court for the Northern District of Texas

Before VAN GRAAFEILAND*, HIGGINBOTHAM, and JONES, Circuit Judges.

JUDGMENT

This cause came on to be heard on the record on appeal and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the District Court in this cause is affirmed in part and reversed in part and rendered in favor of the United States, and the cause is remanded to the District Court for further proceedings in accordance with the opinion of this Court.

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* Circuit Judge of the Second Circuit, sitting by designation.

IT IS FURTHER ORDERED that plaintiffs-appellants pay to defendant-appellee the costs on appeal, to be taxed by the Clerk of this Court.

April 1, 1987

A true copy
Test
Clerk, U.S. Court of Appeals,
Fifth Circuit

By MARGIE THOMPSON
Deputy
New Orleans, Louisiana

ISSUED AS MANDATE: June 8, 1987

APPENDIX E

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

NO. 86-1212

WILLIAM E. CAMPBELL and GWENDOLYN J. CAMPBELL,

Plaintiffs-Appellants
Cross-Appellees,

versus

THE UNITED STATES OF AMERICA,

Defendant-Appellee
Cross-Appellants.

Appeals from the United States District Court for the Northern District of Texas

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ON PETITION FOR REHEARING
(May 29, 1987)

Before VAN GRAAFEILAND*, HIGGINBOTHAM, and JONES, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT

EDITH H. JONES
United States Circuit Judge

May 29, 1987

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* Circuit Judge of the Second Circuit, sitting by designation.

CERTIFICATE OF SERVICE

I hereby certify that three copies of the foregoing PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT have been forwarded via United States mail, postage prepaid, to Michael L. Paup, Esq., Chief, Appellate Section, Tax Division, Department of Justice, P.O. Box 502, Washington, D.C. 20044 on this the 26th day of August, 1987.

_____

William M. Methenitis

Supreme Court, U.S.
FILED
NOV 10 1987
JOSEPH F. SPANIOL, JR.
CLERK

No. 87-341

In the Supreme Court of the United States

OCTOBER TERM, 1987

WILLIAM E. CAMPBELL, ET UX., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

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In the Supreme Court of the United States

OCTOBER TERM, 1987

No. 87-341

WILLIAM E. CAMPBELL, ET UX., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner contends that he is entitled to include in his net operating loss carryback his distributive share of a partnership's losses, even if the partnership itself was not engaged in a trade or business.[1]

1. Petitioner was in the real estate business. A corporation that he owned brokered real estate, and he also acted as a broker individually. He was the sole owner of several parcels of real estate. Pet. App. A1.

In addition, petitioner owned interests in a number of real estate partnerships, each of which, in turn, owned a single parcel of real property. In 1976 and 1977, the partnerships generated losses that were passed through to all

[1] While Gwendolyn E. Campbell is a party hereto by virtue of having joined her husband in the filing of a joint return, William E. Campbell was the principal actor in the transactions at issue. Accordingly, for convenience, we will use the term "petitioner," referring to William E. Campbell.

the partners. Petitioner reported his share of those losses on his income tax returns for 1976 and 1977. Invoking Section 172 of the Internal Revenue Code,[2] petitioner carried back the unused portion of the losses and accordingly received refunds of taxes paid by him for 1973 and 1974. Pet. App. A1, C3.[3]

The Commissioner asserted a deficiency for 1976, and determined a small overpayment for 1977, and disallowed the inclusion of the losses in the net operating loss carryback. The Commissioner's action was based upon his conclusion that the partnerships were not engaged in a trade or business and hence the losses were not incurred in a trade or business as required by Section 172(d)(4) of the Code. Petitioner paid the deficiency for 1976 and sued for a refund of that amount and of the overpayment for 1977. The government counterclaimed for the amounts previously refunded as a result of petitioner's claimed loss carrybacks to 1973 and 1974.

The district court held that petitioner's distributive shares of losses from certain partnerships were eligible for carryback because he had purchased interests in those partnerships for business reasons, namely, as an inducement to prospective partners. The court held that his shares of losses from the remaining partnerships were ineligible for carryback because he had purchased those partnership interests as an investment; investment losses are not treated as losses attributable to a trade or business (see, *e.g.*, *Higgins* v. *Commissioner*, 312 U.S. 212 (1941);

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[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

[3] Section 172 of the Code allows unused net operating loss deductions to be carried back for three years and, if still unused, carried forward for five years. However, in the case of a taxpayer other than a corporation, only business losses may be used to offset business income in computing a net operating loss for a given year and any corollary carryback or carryover to other taxable years. I.R.C. § 172(d)(4).

Moller v. *United States*, 721 F.2d 810, 813 (Fed. Cir. 1983), cert. denied, 467 U.S. 1251 (1984)). Pet. App. A1-A7.

The court of appeals affirmed in part and reversed in part (Pet. App. C1-C6). The court concluded that none of the partnership losses were attributable to a trade or business and therefore that none were eligible for carryback treatment by partners. The court rejected petitioner's contention that the losses must be regarded as business losses simply because petitioner was in the real estate business. Rather, the court held that the nature of a distributive share item is determined at the partnership level, and that nature is then reflected on each partner's return. Thus, if a partnership is not engaged in a trade or business, a partner's share of the partnership's losses cannot be treated as business losses. *Id.* at C4-C5. The court then held that none of the partnerships in question was in a trade or business, noting that each of the partnerships was formed, according to its governing articles, "for investment purposes only." Each partnership held a single parcel of land located in an area of potential urban development, and the annual expenses on the properties in 1976 and 1977 were, on average, 20 times the rental income. Accordingly, the court concluded that the partnerships were "investment vehicles" and were not engaged in a trade or business. *Id.* at C5.

2. Petitioner contends that the character of his share of the partnerships' losses is not governed by whether or not the partnerships were engaged in a "trade or business." This contention was correctly rejected by the court of appeals, and its decision does not conflict with any decision of this Court or of another court of appeals. Accordingly, there is no reason for review by this Court.

The character of items constituting a partner's distributive share is governed by Section 702(b) of the Code, which provides:

> *Character of Items Constituting Distributive Share.* – The character of any item of income, gain,

> loss, deduction, or credit included in a partner's distributive share * * * shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

This language plainly suggests that the partner, in characterizing his distributive share, must look to the partnership entity in order to ascertain the manner in which the item was "incurred by the partnership."

The courts have uniformly recognized this principle. For example, the question whether partnership property is or is not a capital asset as defined in Section 1221 of the Code and, therefore, whether a distributive share of gain from the disposition of the asset must be reported by an individual partner as a capital gain or as ordinary income is resolved at the partnership level (and thus resolved uniformly for all of the partners), not at the level of the individual partner. See *Estate of Freeland* v. *Commissioner*, 393 F.2d 573, 584 (9th Cir.), cert. denied, 393 U.S. 845 (1968); *Grove* v. *Commissioner*, 54 T.C. 799, 804 (1970). And the courts have uniformly held that the existence of a profit motive under Section 183 of the Code likewise must be determined at the partnership level. See *Polakof* v. *Commissioner*, 820 F.2d 321, 323 (9th Cir. 1987), petition for cert. pending, No. 87-529; *Tallal* v. *Commissioner*, 778 F.2d 275 (5th Cir. 1985); *Brannen* v. *Commissioner*, 722 F.2d 695, 703-704 (11th Cir. 1984). Similarly, it is well established that, for purposes of determining whether a partner may take a business expense deduction (I.R.C. § 162(a)) for his share of partnership expenses, the business of the partnership, not of the partner, determines whether the expense was incurred in carrying on a trade or business. *Madison Gas & Electric Co.* v. *Commissioner*, 633 F.2d 512, 517 (7th Cir. 1980); *Barham* v. *United States*, 301 F. Supp. 43, 45 (M.D. Ga. 1969), aff'd, 429 F.2d 40 (5th Cir. 1970); *Goodwin* v. *Commissioner*, 75

T.C. 424, 435-437 (1980), aff'd, 691 F.2d 490 (3d Cir. 1982) (Table).[4]

Petitioner apparently acknowledges the correctness of all of these decisions (see Pet. 7), regarding them as "obvious tenets of partnership tax law" (Pet. 5). He claims, however, that Section 172(d) is different, and therefore he maintains that a partner may carry back his share of partnership losses even if the partnership is not engaged in a trade or business. Petitioner offers no authority to support this proposition, and he does not explain how the statutory language can yield this result while still requiring all other characteristics of various tax items to be determined at the partnership level.

In short, petitioner's argument here is no more than a plea to allow him certain tax advantages that Congress has determined are not available in light of the manner in which he has chosen to structure these particular real estate transactions. This Court has repeatedely noted that, "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice" (*Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974)). Indeed, acceptance of petitioner's submission could well lead to a windfall for him when he avails himself of the benefits of the limited partnership form of ownership. For example, if one of the parcels of

[4] The general concept that income is ascertained and reported at the partnership level, and retains in the hands of the partners the character so determined, was also recognized by this Court in *United States* v. *Basye*, 410 U.S. 441 (1973). The Court there held that a partnership must report as current income payments made into a retirement trust, since the partnership's right to the payments was noncontingent, even though the right of individual partners to receive payments from the trust was not vested. The partners were therefore required to include in income their distributive share of those payments, even though, as individuals, they had no right currently to receive any part of them. The Court explained that, for this purpose, "the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners" (*id.* at 448).

property involved here had been sold, petitioner could have reported his share of the gain on that sale as a capital gain, because the *partnership* was holding the parcel for investment purposes, not in connection with a trade or business, which would have excepted it from the definition of "capital asset" (I.R.C. § 1221(2)). Yet petitioner insists that he is entitled to carry back his share of the partnership's losses as business losses, on the theory that Section 172(d) alone—and incongruously—requires examination of the "trade or business" question at the *partner* level. The court of appeals correctly rejected this contention.

3. Petitioner's contention (Pet. 8-10) that the court of appeals erred in determining that the partnerships were not engaged in a trade or business is similarly without merit. The record showed that each partnership held a single parcel of land, and each partnership agreement stated that the entity was formed "for investment purposes only." Moreover, the rental for the properties averaged only 1/20th of the annual expenses in 1976 and 1977. Thus, the record plainly showed that the partnerships were not engaged in a rental business designed to make a profit; rather, the properties were simply being held as investments and therefore the partnerships could not generate any business losses. Petitioner points to nothing in the record that casts any doubt on this conclusion. In these circumstances, the court of appeals correctly determined that it need not remand the case to the district court, since "the record permits only one resolution of the factual issue." *Pullman-Standard* v. *Swint*, 456 U.S. 273, 292 (1982).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

NOVEMBER 1987

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